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LIVING WITH THE TRADE DEFICIT:
ADJUSTMENT STRATEGIES TO PRESERVE FREE TRADE
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Summary

Washington's track record in devising policies to help American manufacturers and workers hard hit by imports adapt to the new conditions of competition is mixed at best. More often than not, these programs end up delaying adjustment rather than facilitating it. With foreign competition squeezing operations in a lengthening list of U.S. industries, there is an immediate need for effective government policies to ease the economic dislocations caused by trade. In the following article, Robert Z. Lawrence and Robert E. Litan, senior fellows in the Economic Studies program at The Brookings Institution, propose one such strategy, a combination of four years of declining tariff relief for industries found to be hurt by imports and automatic adjustment assistance for workers displaced by imports.

Introduction

Supporters of free trade are on the defensive. A rising trade deficit -- threatening to top \$150 billion this year [1985] -- and sluggish economic growth have encouraged the introduction of more than 300 bills in Congress to restrict access by foreign goods to the U.S. market. Unless the trade gap

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narrows, the prospects are good that some type of protectionist legislation will be enacted before the 1986 mid-term congressional elections.

Most economists decry this apparent drift toward protectionism. They tirelessly point out that the primary reason for the high and rising trade deficit is the succession of record federal budget deficits, not the barriers to trade maintained by other nations (see box). After all, they reason, the trading system is no more unfair to the United States today than it was in 1981 when the United States enjoyed a positive trade balance in manufactured goods.

At the same time, however, there is growing concern among both politicians and economists about the long-range implications of the current trade imbalance. Last spring, the United States became a net debtor nation for the first time since 1941, largely as a result of unprecedentedly high borrowing from foreign creditors who help to finance the growing trade deficit. Continued increases in debt owed to foreign nations will ultimately be paid for by sacrifices in future living standards, through shipments to foreign purchasers of U.S.-produced goods that American consumers would otherwise enjoy. If this debt repayment is attended by a substantial depreciation of the dollar -- which many economists believe is inevitable -- the cost of imported goods will climb and the rate of inflation will increase.

Erecting trade barriers here, either as bargaining chips or as purely protectionist devices, would only make matters worse. Added trade restrictions would strengthen the dollar and reduce the competitiveness of American goods in world markets. Also, a turn toward protectionism by the United States could trigger retaliation by other countries, leaving all trading nations worse off, as occurred in the 1930s after the United States passed the infamous Smoot-Hawley Tariff Act. Finally, curtailing imports from countries now heavily in debt, such as Brazil and South Korea, could strain the American banks to which this debt is owed and threaten the viability of an already fragile financial system.

Many of the new congressional advocates of protection are cognizant of its dangers, but argue that protectionist measures are needed to close the worsening trade gap. One cynical explanation is that lawmakers are using the growing trade deficit to make foreign countries the scapegoats for the recent hiatus in the U.S. economic recovery. A more compelling explanation is that lashing out at foreign trade barriers can be more attractive politically than tackling the complex and divisive task of reducing the principal cause of the current trade imbalance: the federal budget deficit, which most forecasters outside the administration expect to exceed \$100 billion a year through the end of the decade.

In such an environment, repeated calls by economists, the news media, and other opinion leaders for budget discipline as a means of paring the trade deficit are likely to fall on deaf ears in Congress, which is pressured continually by workers and firms in trade-sensitive sectors of the economy that have been battered by the strong dollar. To be sure, the dollar has weakened somewhat in the wake of the Treasury Department's recent commitment to intervene with the finance ministries of Japan, England, France and West Germany in

The Link Between Federal Budget Deficits and Trade Deficits

The U.S. current account -- the net balance of exports and imports of goods and services -- can be directly linked to the U.S. budget deficit. This is because the current account balance is, by definition, equal to the difference between national saving and national investment. At any given level of employment, if the government seeks to increase its consumption, either the private sector will have to consume less or the goods will have to be obtained from abroad. Thus, given private investment and savings behavior, an increase in the government deficit will translate, dollar for dollar, into a decline in the current account balance. This means the size of the current account balance is not so much an indicator of a nation's competitiveness as it is of the nation's spending behavior.

These principles can be derived algebraically from the definitions of Gross National Product (GNP) and Gross National Income (GNI), which must be identical. GNP is the sum of Private Consumption (C), Private Investment (I), Government Spending (G), Exports of Goods and Services (X), minus Imports of Goods and Services (M), or

$$\text{GNP} = C + I + G + X - M.$$

GNI, meanwhile, equals the sum of Private Consumption (C), Private Saving (S), and Tax Revenues of the Government (T), or

$$\text{GNI} = C + S + T.$$

Since GNP must equal GNI, the above two identities can be set equal to each other, as follows:

$$C + S + T = C + I + G + X - M.$$

After subtracting C from each side, these terms can be rearranged into the following fundamental identity:

$$(S - I) + (T - G) = X - M,$$

or Net Private Saving + Net Government Saving = Current Account Balance.

In short, the current account balance equals the sum of net private and government saving. Figure 1 shows what has happened to each of the components of this identity since 1977. Significantly, the current account balance began to turn negative as the total government deficit (dis-saving) began to rise. The current account balance has deteriorated most sharply since 1982, when net private saving dropped precipitously and the total government deficit was then exceeding 3 percent of GNP.

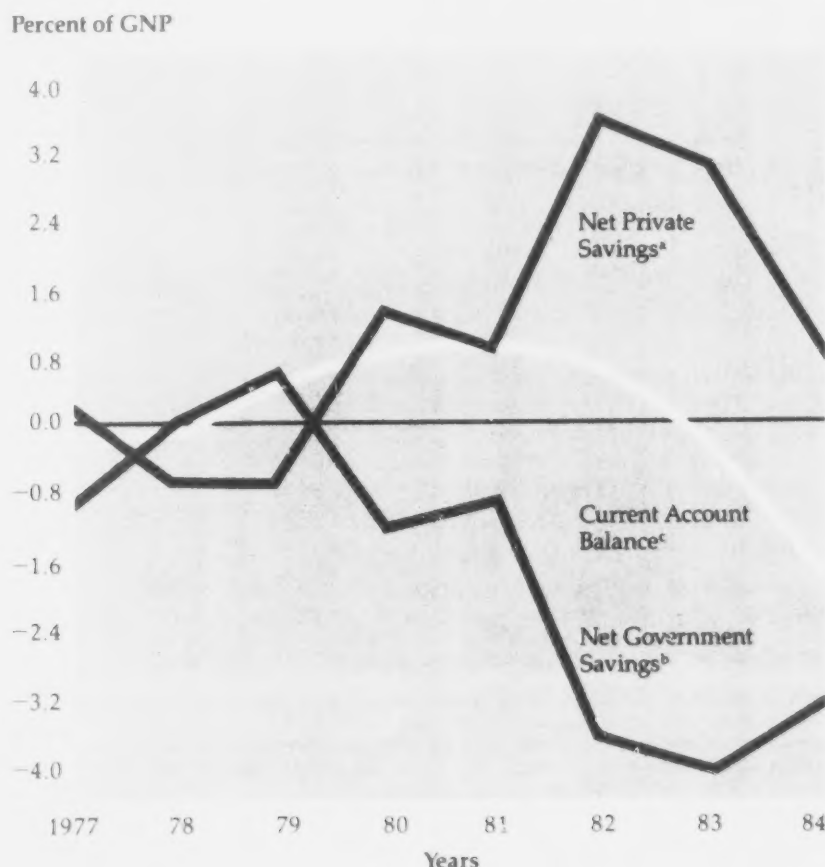
foreign exchange markets. In addition, the political momentum behind protectionism abated somewhat following the administration's announcement of its intention to step up enforcement of the laws against unfair trade practices. Nevertheless, the political impulses to embrace protectionist remedies remain strong. They will continue to push the administration away from policies

favoring freer trade; even more dangerously, they could lead to concrete protectionist actions should U.S. economic growth continue to stall or the economy slide into recession.

Rather than acceding to protectionism, lawmakers should develop effective policies for easing the dislocations induced by trade. Politicians continue to face pressures for protectionism from firms, workers, and communities adversely affected by import competition; lawmakers can and will find it difficult to resist calls for trade barriers if they cannot point to policies that mitigate the economic pain caused by changes in trade patterns. Put in economic terms, aid for trade-injured parties can reduce both the demands for protection and the willingness of elected leaders to supply it.

The United States has attempted in the past to provide such assistance, but with mixed success. We believe that the nation can do better, but only if programs are designed to promote, rather than delay, adjustment to change. The cruelest form of aid is one that, in the end, leaves recipients in even worse shape to deal with the harsh competitive realities of the global marketplace. The danger of this outcome can be reduced if trade assistance programs meet the following criteria:

Figure 1.
Savings and Current Account
Balances as Percent of GNP,
1977-84



^a Equals gross private saving minus gross private investment, as percent of GNP.

^b Equals total revenues minus expenditures of all governments (federal, state, and local), as percent of GNP.

^c Equals exports, minus imports (goods and services), as percent of GNP.

-- Assistance must be temporary, so that it does not encourage dependence.

-- Assistance must be transparent, so that voters and politicians are aware of its costs.

-- Assistance must complement, rather than replace, market forces.

Below we present several detailed proposals based on these criteria. In part, our suggestions envision a fundamental redirection of two programs already in place: the temporary protection available through the current U.S. "escape clause" law and the help provided to some workers under the trade adjustment assistance program. Under our proposals, two types of aid would be triggered by an International Trade Commission (ITC) determination that an industry is suffering serious injury because of import competition. First, firms in the industry would be eligible for temporary protection from imports in the form of tariffs, but not quotas. Mergers of such firms would be judged under antitrust standards that recognize global competition. Second, workers in the industry would be eligible automatically for payments geared to their losses in income and for loans to finance retraining, with repayments based on future income and collected through the income tax system. We conclude by outlining a novel plan, not tied to ITC determinations, for enabling communities to insure against sudden losses in their tax bases due to trade-related or other economic dislocations.

Assisting Adjustment by Industry

Special assistance programs for industries adversely affected by import competition are considered justified on economic grounds in two circumstances. First, when changes in trade patterns reflect fundamental shifts in comparative advantage, targeted industry assistance can cushion the economic pain suffered by firms, their workers, and the communities in which they are located. Second, when a sudden surge of import competition is due to temporary factors, industry aid can prevent or minimize unnecessary losses in physical and human capital. For example, a nation may have a long-run comparative advantage in producing high-quality shoes or clothing. However, due to sudden relaxations in trade barriers or movements in exchange rates, its footwear and clothing industries may be temporarily unable to compete effectively with foreign producers. Without some short-term assistance to tide them over, firms in these industries can be severely and permanently damaged, large capital investments destroyed, and a trained labor pool lost forever.

The Current Assistance Program - In recognition of the potential value of assistance in the above circumstances, the United States and other nations allow temporary protection of domestic industries. The General Agreement on Tariffs and Trade (GATT), currently signed by over 80 nations, permits member countries to "escape" temporarily from tariff concessions and other obligations under the agreement if, as a result of such concessions, imports threaten or cause serious injury to domestic producers.

The U.S. escape clause law, set forth in sections 201 through 203 of the Trade Act of 1974, allows relief for up to five years if domestic industries can demonstrate to the ITC that they face serious harm from import competition.

(This law is more liberal than the GATT because it permits temporary protection even if the harm to the domestic industry is not a result of the removal of trade barriers under the GATT.) Import protection is not automatic, however. Even when the ITC finds the requisite serious injury, the president has substantial discretion. He may impose tariffs or quotas; negotiate orderly marketing agreements (OMAs), which are in effect bilateral quotas; recommend expeditious consideration of worker requests for adjustment assistance; or grant no relief at all.

The principal advantage of the escape clause is that it establishes an administrative mechanism that removes pleas for protection from the domain of elected officials. The clause has been fairly successful at keeping protection temporary. Of the 30 industries that have received protection in Section 201 cases since 1950, only two -- motorcycles and specialty steel -- remain protected today. By contrast, protections obtained directly from the Congress or through country-to-country agreements (as in the case of quotas for imports of textiles, beef, and sugar) have as a practical matter been permanent. Indeed, it is unfortunate that Congress has not required the ITC to provide regular reports on the impacts of the measures on consumers, firms, and workers. Such reports would at least expose to public view the costs and benefits of continued protectionism -- and Congress should provide for them if it decides to give permanent quota protection to the textile, footwear, and other domestic industries.

Criticisms of the Current System and Some Proposals for Change - The escape clause mechanism, however, is an imperfect method for assisting adjustments by trade-injured firms. Experience with other kinds of trade restraint suggests that protectionism, even if it is temporary, is expensive because it raises prices of all products -- both foreign and domestic -- in a protected market. Susan Hickok of the Federal Reserve Bank of New York estimates that current U.S. trade barriers are costing consumers at least \$14 billion per year. Our colleague, Robert Crandall, has calculated that one barrier -- the so-called "Voluntary Restraint Agreement" that limited exports of Japanese automobiles to the United States -- alone cost American consumers over \$4 billion annually in high prices [see JEI Report No. 46A, December 7, 1984], until the arrangement was allowed to expire earlier this year. According to Crandall, the cost per job saved in the automobile industry was \$160,000 per year -- more than four times the average annual compensation of auto workers!

Not surprisingly, therefore, most economists urge that if trade-related assistance is to be provided at all to industry, it take the form of direct subsidies. In principle, subsidies are more efficient than tariffs or quotas because they do not distort the relative prices of goods and, therefore, do not disturb consumption patterns. However, in the current budget climate, it is unrealistic to expect Congress to adopt this "first-best" solution. Moreover, it is questionable whether direct subsidies allotted through the political process would be as efficient as is often thought. In theory, subsidies should be allocated to those firms offering the highest prospective returns. In practice, the political process tends to allocate subsidies on bases other than pure economic criteria.

Of course, the design of a non-subsidy protection program presents its own set of difficulties. One challenge is to ensure that any protection

granted is cost-effective. This goal can be realized only if the form of protection promotes rather than delays adjustment; otherwise, society will be forced to suffer the pain of higher prices without reaping the benefits that protection is designed to achieve.

A second challenge is to avoid making protection either too easy or too difficult to obtain. If it is too readily granted, protection will be awarded in many instances in which it is not appropriate, producing unnecessary costs for consumers. On the other hand, if escape clause relief is rarely forthcoming, domestic industries and their workers will seek other, perhaps more lasting and invidious forms of protection directly from the Congress. For example, President Reagan's decision in September, 1985, to reject the ITC's recommendation that the U.S. shoe industry receive temporary import protection is widely credited with intensifying protectionist sentiment in Congress. The result could be legislated protection, for years to come, of the U.S. shoe industry and other domestic industries; this would be far more costly to consumers than the declining quotas for footwear imports recommended by the ITC.

Many members of Congress are dissatisfied with the current U.S. escape clause law, and a variety of proposals have been made to change it. Unfortunately, some of these could actually reduce the capability of the escape clause mechanism to meet the two challenges just discussed.

One class of proposals, for example, would weaken the current legal causation standards, by which the ITC determines whether an industry's poor economic health has been caused by import competition. These proposals are difficult to justify in light of experience under Section 201. Since the standards were last eased in the 1974 Trade Act, the ITC has found import-induced injury in 32 of the 55 cases in which petitions for escape clause relief have been filed -- a "success" rate for domestic industries of almost 60 percent. Since some undeserving cases are now presented to the ITC, this proportion suggests that further relaxation of the causation test could yield an excessive degree of protection.

Another class of suggestions would make import relief conditional on commitments by domestic industries to modernize and reinvest. The model for this conditionality approach is the 1980 loan guarantee package for Chrysler, which Congress approved only after management and labor at the company agreed to a number of conditions on the firm's operations, including limits on employee compensation. Last year, Congress extended the conditionality concept to the steel industry, which benefits from export restraint arrangements with other steel-exporting countries. In the 1984 Trade Act, Congress conditioned the continuation of these arrangements on an annual presidential certification that major U.S. steel companies are reinvesting all their net cash flow in the steel business.

However, the Chrysler analogy is inapposite to the trade context. It is one thing for a creditor, such as the U.S. government, to impose conditions on a single debtor as a price for receiving credit or other financial assistance. It is quite another thing for government, not acting as a creditor, to negotiate conditions for an entire industry. That process inevitably facilitates coordination by domestic competitors of investment plans, product strategies,

and even pricing decisions. The result can be cartel-like behavior that is totally at odds with U.S. antitrust laws and inconsistent with the interests of American consumers.

Equally significant, the conditionality approach violates our criterion that trade relief not be permitted to replace market forces. Conditionality unjustifiably presumes that government officials possess knowledge or information superior to that of the private sector. However, as in the 1984 Trade Act's reinvestment requirements for the steel industry, the bias of government will always be toward the expansion and modernization of a trade-injured domestic industry. Economic reality often confutes that bias; trade difficulties generally signify a need for exit from an industry, not for additional investment in it. Indeed, our analysis of a sample of 16 industries that received some type of import protection over the last two decades indicates that only one of them, the bicycle industry, increased its production and employment levels after protection was removed. The rest shrunk in size, although some were more successful than others in developing and introducing new products and technologies. Had the government required each of these industries to meet the kind of reinvestment conditions imposed on the steel industry in 1984, much investment would have been wasted.

A final class of proposed reforms stems from congressional criticism of how much discretion the current escape clause law allows the president once the ITC determines that import competition has seriously injured a domestic industry. Since 1975, the president has granted import relief in only 13 of the 32 cases in which the ITC has made an affirmative escape clause finding (although in five other instances, he has recommended expedited consideration of adjustment assistance for displaced workers). Given this record, some lawmakers have suggested the elimination of presidential discretion to accept or reject the ITC's import relief recommendations. Others have urged that the decision to impose import barriers be vested in the United States trade representative (USTR), subject to a presidential override. This proposal seems to assume that the USTR would be more likely than the president to grant import relief once the ITC made an affirmative injury finding.

We favor some narrowing of presidential discretion under the escape clause procedure, but we do not support the proposals lawmakers have so far considered. Granting automatic import protection to industries found to be suffering from import-induced injury would run a dangerous risk of imposing too much protection. This would not only harm consumers, but damage relations with foreign trading partners. On the other hand, a transfer of import relief authority to the USTR would be unlikely to accomplish the objectives of its proponents, since the head of that office serves at the pleasure of and reports to the president.

Our Alternative Proposals - We recommend that the current law be changed in two respects. First, if the president decides to grant any import protection at all under the escape clause, he or she would be limited to imposing a four-year schedule of declining tariffs. In addition, all existing quotas (such as those on textiles, steel, beef, and sugar) would be replaced with tariffs set in advance to decline, but perhaps over periods longer than the five years provided for in the current escape clause. The first-year tariff levels would be established through auctions of quota rights.

Second, although the current legal standards for proving import-induced injury should remain intact, two components of relief should be triggered automatically upon an affirmative finding by the ITC. Workers in an affected industry who are laid off in the four years following the filing of a successful petition would become eligible for adjustment assistance (as described below). Revenues from any tariff imposed under the escape clause law would be earmarked to fund the assistance, with supplements from general appropriations as required. In addition, firms in an affected industry would be judged by proposed mergers involving antitrust standards that gauge competitive impacts in terms of the international market, rather than just the domestic one, provided that the industry is not benefiting from import protection. A change of this sort, which the administration has also been considering, would make approval of such mergers more likely.

This plan has a number of advantages. Its first feature eliminates the least cost-effective means of providing temporary industry assistance: quotas or OMAs. Unlike tariffs, the cost of which are transparent to consumers and lawmakers, quotas pose hidden costs. Perhaps more important, they make it easier for domestic producers with market power to increase their prices. Tariffs penalize imports, but also allow them to enter freely and act as a competitive check on outsized price hikes. Moreover, tariffs yield additional revenue for the government; quotas do not.

The second aspect of the plan -- the automatic relief components -- should provide sufficient ammunition to lawmakers to fend off demands for legislated protection. In contrast with current law, which vests certification authority in the ITC for import relief and in the Labor Department for adjustment assistance, the proposed plan would make both kinds of relief contingent on a single proceeding. Workers adversely affected by trade would not have to wait for adjustment assistance, which in the past has often become available only after displaced workers have already found new employment.

Finally, the proposed revision of antitrust standards for mergers involving companies in impacted industries would be, compared to the present system, a more socially productive strategy for inducing such firms to seek Section 201 relief instead of legislated alternatives. Under current antitrust law, merger standards are relaxed only for specific failing companies, not for all firms in a particular industry, and, in fact, the criteria for qualifying as a failing company are rarely met. In addition, until recently government assessments of the competitive impact of proposed mergers have rarely taken foreign producers into account. Our proposal would force antitrust officials to recognize that firms meriting relief under the escape clause are competing in world markets in which, in all probability, fewer firms with less capacity can survive. We reject, however, the Commerce Department's proposal to exempt such firms from merger standards altogether. This could produce highly concentrated markets, to the detriment of consumers.

Our plan does raise one complication in light of the current GATT rules for escape clause actions, which require the United States and other signatories to compensate trading partners when erecting tariff barriers. We believe that this requirement should be suspended when protection results from a transparent legal process and takes the form of self-liquidating tariffs. An exception in these circumstances would be far more in keeping with the spirit of the

GATT than the current compensation provisions, which, unfortunately, countries have avoided by resorting to discriminatory quota and voluntary export restraints that threaten to undermine market-based trade.

Assisting Adjustment by Workers

The Current Assistance Program - In principle, there is no reason why workers displaced as a result of import competition should be treated better than those dislocated because of other developments, such as technological improvements or shifts in demand patterns. Nevertheless, when it was first introduced in 1962, trade adjustment assistance for workers was justified as a means of compensating those adversely affected by tariff reductions. Currently, such assistance can be viewed as compensation for the more general dislocation costs of open trade. Presidents Ford and Carter, when subject to politically pressing demands for protection during election years, made effective use of trade adjustment assistance for affected workers. As shown in Figure 2, however, the Reagan administration has severely curtailed the most important component of trade adjustment assistance, Trade Readjustment Allowances (TRAs), despite unprecedented trade pressures.

Unfortunately, defects in the design of the trade adjustment assistance program in recent years have obscured its potential usefulness as an anti-protectionist device. First, the manner in which TRA assistance has been provided has tended to discourage, rather than facilitate, worker adjustment. Congress recognized this problem in 1981 when it abandoned the previous TRA compensation system, which provided assistance to workers only during weeks in which they also collected unemployment insurance. Congress believed that this system encouraged displaced workers to stay home, rather than to seek new employment.

The new TRA compensation system, urged upon Congress by the Reagan administration and adopted in 1981, attempts to correct the incentive problem. Under the new system, trade-displaced workers not enrolled in retraining programs are eligible to collect TRA only after they have exhausted their unemployment compensation benefits. The period during which they get either type of aid may not exceed 52 weeks. For example, a worker who has received 39 weeks of unemployment compensation can then be eligible for no more than 13 weeks of TRA. (There is an exception to this rule: A worker can qualify for an additional 26 weeks of TRA payments by enrolling in a retraining program.)

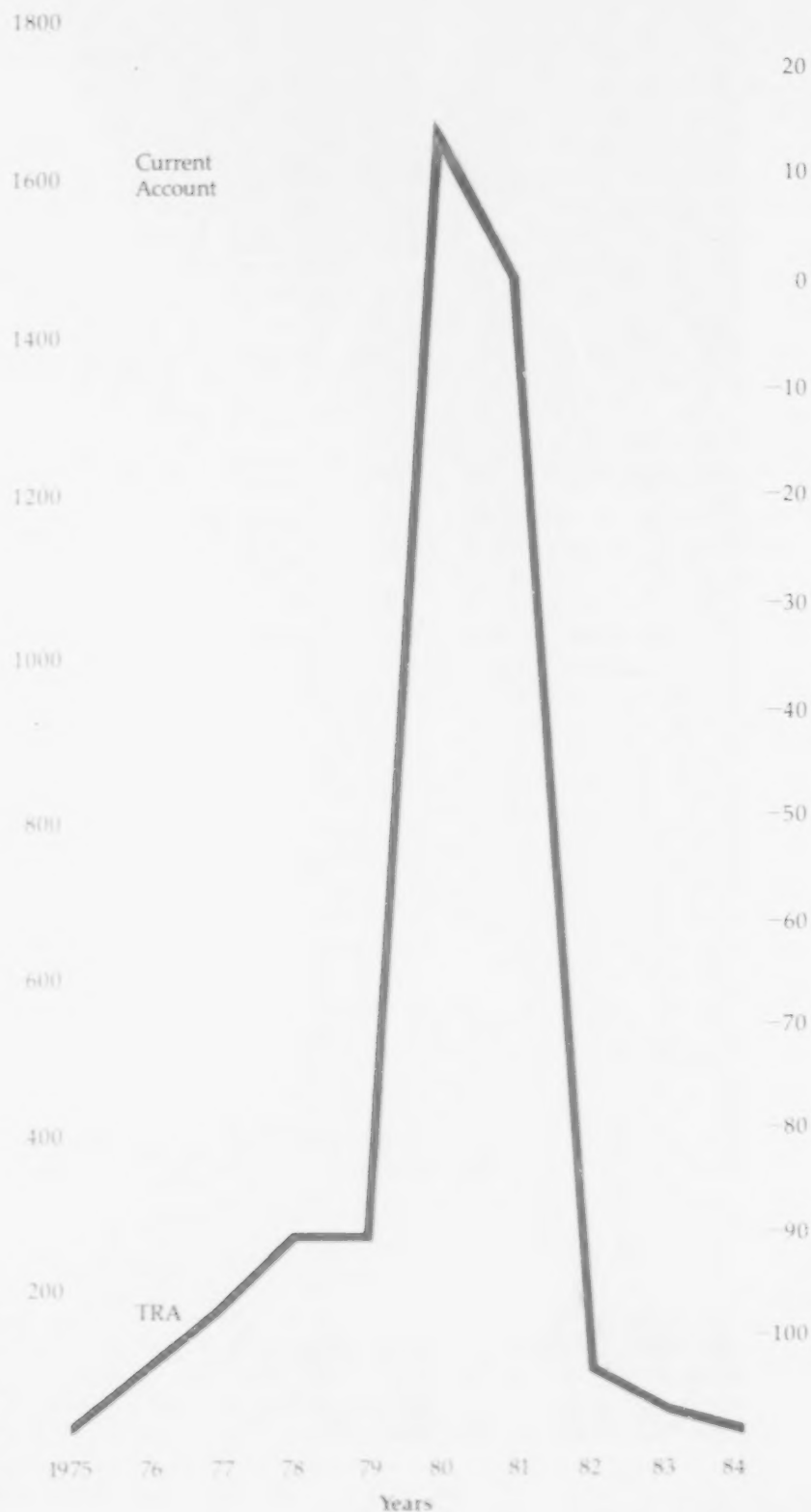
The Reagan-era TRA program appears to have encouraged trade-displaced workers to pursue retraining, but not necessarily to search for and obtain new jobs. As shown in Table 1, the fraction of all workers receiving TRA benefits who entered retraining programs has increased sharply during the Reagan administration -- from 3.8 percent in fiscal years 1976-81 to 31.3 percent in fiscal years 1982-84. However, while the proportion of workers who have finished retraining programs has also risen, the percentage actually obtaining jobs for which their retraining qualified them has fallen -- from 7.6 to just 4.1 percent. These figures suggest that the TRA compensation system adopted in 1981 may have encouraged some workers to undertake retraining programs merely to continue collecting TRA benefits rather than searching for meaningful employment.

More generally, Table 1 indicates that, despite the incentives adopted by Congress in 1981, the preponderance of trade-displaced workers -- 68 percent

Figure 2.
Trade Readjustment
Allowances (TRAs) and
Current Account
Balance

Trade Readjustment Allowances
(Millions of dollars)

Current Account Balance
(Billions of dollars)



Note: TRAs based on fiscal years; trade balance on calendar years

Sources: Employment and Training Administration, Dept. of Labor, unpublished data; Economic Report of the President, Council of Economic Advisers, February, 1985; Economic Indicators, Council of Economic Advisers, August, 1985

-- have not sought retraining. These workers are simply not being encouraged to find work by the 1981 TRA compensation system, which tacks TRA payments onto the end of the unemployment compensation period.

The second problem with previous trade adjustment assistance programs is that the levels of compensation they have provided have borne a highly imperfect relationship to the economic losses that trade-displaced workers have actually sustained. In principle, those losses are equal to the total earnings missed due to unemployment plus the decline in earnings capacity in subsequent employment. For example, a steelworker who because of import competition is let go and must eventually accept a job as an auto mechanic loses not only income during unemployment, but also the value of his or her unutilized steel-making skills (including both forfeited "human capital" and accumulated seniority).

Current and previous TRA compensation formulas have taken account of only the first of these components of earnings loss. The pre-1981 compensation system, for example, provided TRA and unemployment compensation benefits totaling 70 percent of a worker's former gross weekly wage (but not more than the national average of weekly manufacturing wages), minus amounts received for retraining and 50 percent of part-time earnings. Since 1981, displaced workers have been entitled only to extended TRA benefits equal to previous unemployment

Table 1: Trade Adjustment Assistance Data, Fiscal Years 1977-84

	<u>FY 1977-81</u>	<u>FY 1982-84</u>
(1) Total number of workers receiving TRA benefits	1,211,206	76,316
(2) Total number of workers who entered retraining	46,504	23,876
(3) Worker retraining ratio (2)/(1)	3.84%	31.29%
(4) Total number of workers who completed retraining	16,926	11,055
(5) Retraining completion ratio (4)/(2)	36.4%	46.3%
(6) Total number of placements after retraining*	3,509	968
(7) Placement retraining ratio (7)/(2)	7.55%	4.05%

*Placements, as a result of retraining, based upon specific job definitions used by state employment service agencies.

Source: Employment and Training Administration, Office of Trade Adjustment Assistance, Department of Labor.

compensation amounts, which are based roughly on a worker's prior earnings. Neither compensation formula has reflected declines in the earnings capacities of workers in subsequent employment. Two individuals who are unemployed for the same length of time may ultimately find new jobs paying vastly different wages, but under the present system both would receive the same amount of TRA.

Current Reform Efforts - At this writing, Congress is considering a reform bill, authored by Senator William V. Roth, Jr., that would only partially cure these defects. The Roth proposal would extend the maximum benefits period from 52 weeks to 78 weeks. It would require workers receiving benefits to be enrolled in, or to have completed, a training program funded by a \$4,000 job retraining voucher. Vouchers would be redeemable for training in a variety of programs, including those under the Job Training Partnership Act, those approved by the secretary of labor, and those conducted without federal support by private firms. The Roth plan would be financed by an across-the-board import fee of up to 1 percent; the precise level would be set by the president. Congressman Donald J. Pease has introduced a House bill similar to the Roth proposal.

Although the Roth-Pease approach makes a constructive effort to increase worker skills, it has several important flaws. First, it would force workers to enroll in retraining simply to obtain extended unemployment compensation, rather than because the retraining would be cost-effective. Training may be useful for some workers, but a waste of time for others. Indeed, the track record of the Reagan administration's TRA program, in which only 4.1 percent of workers were placed in jobs for which they were trained, points to the limitation of this approach. In our view, subsidized training should be an option available to displaced workers, but it should be neither mandatory nor free.

A second flaw in the Roth-Pease proposal is that by extending unemployment benefits but not compensating workers who find alternative employment, it would continue the subsidization of those who fail to seek new jobs. Finally, although the basic rationale for adjustment assistance is to compensate those hurt when trade is kept free, the Roth-Pease program would also perpetuate the error of granting benefits to workers even if the industry from which they are displaced is protected by quotas -- the worst form of protection.

Our Alternative Proposal - In our judgment, a superior adjustment program would make compensation, training, and relocation benefits available automatically to workers displaced from industries that the ITC determines to be suffering serious injury from imports. The program could also be used to aid workers displaced from industries currently protected by quotas, such as textiles and steel, provided that the quotas are replaced with self-liquidating tariffs.

The compensation component of our proposal would provide qualified displaced workers with two types of earnings-related payments: unemployment compensation and earnings insurance. Existing unemployment compensation programs, which currently compensate eligible unemployed workers for up to 26 weeks in virtually all states, would be left undisturbed. In addition, trade-displaced workers residing in regions of high unemployment, where alternative jobs may be less plentiful, would be eligible for an additional 26 weeks of unemployment compensation payments. Any qualified worker who chose to move in order to obtain new employment would be eligible for a relocation allowance.

Earnings insurance payments, in contrast, would be made to trade-displaced workers only upon their accepting new employment; payments would equal a fixed percentage of any erosion in earnings for a particular period of time. Thus, if the compensation ratio were 50 percent, a displaced worker from a designated industry who had earned \$20,000 a year in wages (as reflected on the worker's previous tax returns) and had accepted a new job with a salary of \$10,000 would receive, for a specified period, supplementary payments calculated from a base of \$5,000 per year. The proportion of income replaced could decline over time and could reflect the age and experience of workers. (For example, more junior workers who have built up less human capital in their specific job skills might receive lower replacement rates.) Also, the total compensation payments made to any worker over a given period could be subject to a legislated ceiling.

This proposed earnings insurance mechanism, in conjunction with unemployment insurance, would represent a significant improvement upon current and proposed trade adjustment assistance programs. By providing extra compensation to workers after they find new employment, the proposal would give them an incentive to adjust. Rather than remain idle in the hope of reemployment with their old firms, workers could accept jobs paying lower wages (but offering new career opportunities, training programs, and chances to build up seniority).

A second component of our proposed program would aid workers who prefer to enroll in state-certified training programs. Training expenses would be financed by a combination of grants and loans. Repayment of loans would be made directly through worker's tax returns and would begin only after workers have surpassed their previous peak wage earnings, as reflected on earlier tax returns. The proportion of the retraining cost repaid would vary with the incremental earnings of workers. Workers who exceeded their previous earnings by a large percentage would be expected to repay a larger percentage of their training costs. Such contingent repayment loans -- already in effect at some colleges -- would allow the government to take equity positions in its citizens. Indeed, contingent repayment should be made a feature of other educational and training loan programs.

Advantages of Our Industry and Worker Assistance Proposals: The Auto Industry as Case Study

The advantages of providing trade protection only in the form of tariffs and using the resulting revenues for trade adjustment assistance in the manner just outlined can be illustrated by examining what would have occurred if, from 1980 to 1984, such a program had been in effect instead of the Voluntary Restraint Agreement (VRA) regarding the export to the United States of Japanese automobiles.

According to the Department of Labor, between 1979 and January, 1984, 225,000 workers were displaced from the U.S. automobile industry. By January, 1984, two-thirds of these workers were reemployed, at median annual earnings some \$4,000 per worker less than before. A tariff providing protection equivalent to that of the VRA would have easily funded a program to compensate for these earnings losses. According to Robert Crandall, whose analysis appeared in the Review earlier this year, the VRA increased the average price of Japan-

ese cars by \$1,000 in 1983. The tariff equivalent of this \$1,000 per car increase would have yielded \$1.85 billion in revenues. Such a sum not only would have funded full compensation for the annual income erosion of all re-employed auto workers (total cost \$603 million), but also would have generated \$16,000 for each remaining unemployed worker.

These calculations suggest that even a smaller auto tariff -- one that would have provided some relief for American consumers -- would have been more than sufficient to fund our recommended assistance program. According to Crandall, the VRA raised U.S. automobile employment by 46,200. Assuming that a tariff set at half the equivalent level of the VRA would have yielded only a corresponding half increase in reemployment, 23,100 workers would have been displaced. However, with such a lower tariff, U.S. consumers would have saved at least \$500 dollars per Japanese car purchased (and approximately \$200 dollars for each American car purchased). The revenue raised (\$925 million) would have sufficed to offset two-thirds of the income lost by displaced workers reemployed at lower wages (a total cost of \$445 million) -- and still yield \$5,860 per unemployed worker for extended unemployment compensation, retraining, and other dislocation assistance.

The experience of the automobile industry over the past four years illustrates well the advantages of our proposal over trade quotas -- particularly because that experience poses a severe test. For one thing, a large number of workers who were indirectly aided by the VRA would not have qualified for our program because they were not actually displaced by imports. For another, given their above-average wages, autoworkers as a group experience relatively large earnings losses. In more typical cases, in which more of the employment displacement would be due to imports and workers would suffer less erosion of earnings than autoworkers did, the benefits of our plan could be even greater and the cost even lower.

Assisting Communities

A third major source of political pressure for protection is concern about the impacts of major plant closures on particular communities. Given the large fixed overhead costs of public facilities -- schools, utilities, police and fire services -- communities in which such closures occur are often forced to add the insult of additional taxes to the injury of an already shrinking populace. Although the concern about these effects has influenced the design of the trade adjustment assistance program, aid to impacted communities has been a virtually nonexistent part of the effort. In its absence, the only mechanism for helping these communities has been legislation adopted in a number of states requiring companies to provide notice in advance of plant closings.

We suggest that a new, positive approach be tried for assisting communities adversely affected by structural changes in the economy. Our proposal would not rely on general appropriations, because that route has proven to be a poor way to target regional assistance. In contrast to the relative success of the ITC procedures, which tie assistance to showings of trade-induced dislocations and confine aid to qualified industries, programs for aiding distressed regions -- such as the Model Cities initiative and the work of the Economic Development Administration -- have tended to expand beyond their original purposes.

Under our approach, communities would voluntarily choose to insure their tax bases against sudden erosion, rather than to depend on a government grant program. The tax base insurance program might, for example, allow a city experiencing an annual loss of more than 5 percent of its tax revenues for reasons other than rate reductions to recover from a government-administered insurance pool some proportion of that loss. The percentage threshold for tax base loss would vary by community size; a lower percentage loss would be required for larger cities. The pool would be financed through insurance premiums paid by communities that elect to join the program. Because the insurance coverage would extend to all sudden diminutions in a community's tax base, all types of communities, not just those experiencing steady long-term population erosions, would be encouraged to participate.

It is possible, of course, to confine such a program to trade-related tax base losses. A mechanism similar to the Section 201 procedure now in effect for industries harmed by trade could be established to determine the causal role of trade in regional economic injury. However, given the voluntary and potentially self-financing nature of our tax base insurance plan, there is no reason in principle or practice why the program should be so restricted.

Conclusion

It is ironic that, despite its commitment to free trade ideals, the Reagan administration has resorted to more extensive quota protection than its recent predecessors. The irony is compounded by the administration's own macroeconomic policies, which stimulate pleas for protection, and by administration cutbacks of adjustment assistance programs that, if effectively designed, could allow a non-protectionist response. Given the current, dangerously protectionist environment, the programs outlined in this article could be an effective microeconomic adjustment strategy complementing the fiscal policy corrections that are required to place the U.S. economy on a path of sustainable growth without permanent protection.

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